

## TEACHERS' RETIREMENT BOARD

### INVESTMENT COMMITTEE

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SUBJECT: Internal Equity- Cash Equitization Policy

ITEM NUMBER: 4

ATTACHMENT(S): 3

ACTION: X

DATE OF MEETING: January 13, 1999

INFORMATION: \_\_\_\_\_

PRESENTER(S): Mr. Tong

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### **Executive Summary**

In February 1998, Pension Consulting Alliance (PCA) presented an agenda item to the Investment Committee defining the concept of cash equitization. The Investment Committee directed staff to complete further analysis to identify the viability of a cash equitization program for the California State Teachers' Retirement System (STRS) and report the findings or recommendation(s) to the Investment Committee. In October 1998, staff presented a comprehensive report on a cash equitization program. This report described specific uses for equitized cash and discussed implementation issues for the STRS domestic equity portfolio. The Investment Committee approved the concept of cash equitization subject to approval of policies.

The proposed policies for the STRS Cash Equitization Program are included as Attachment 1. The policies are designed to set the boundaries that will ensure prudence and care in the implementation of the Cash Equitization Program. Also, the policies are static in nature and cannot be changed without approval of the Investment Committee.

PCA has reviewed the proposed policies and in Attachment 2 has provided a synopsis of the review and recommendation.

### **Recommendation**

Staff recommends Investment Committee approval of the policies for the STRS Cash Equitization Program by adopting the attached resolution (Attachment 3). PCA has reviewed the proposed policies and concurs with staff recommendation for approval.

## **California State Teachers' Retirement System Cash Equitization Program Policies**

### **Introduction**

On October 7, 1998, the California State Teachers' Retirement System (STRS) approved implementation of a cash equitization program for the domestic equity portfolio subject to Investment Committee approval of policies. The primary reason to consider a cash equitization program is to provide a mechanism to enable the domestic equity exposure to remain closer to the adopted strategic asset allocation policy target. A cash equitization program would allow STRS to maintain market exposure and minimize expected tracking error without impacting the active domestic equity manager's investment decisions.

### **Policies**

Policies for the management of the STRS Cash Equitization Program (Program) are listed below. The policies are static in nature and cannot be changed without approval of the Investment Committee.

1. The Program's objective is to substitute a S&P 500 Index return for a cash return.
2. The Program will pursue its investment objective by investing in S&P 500 Index futures contracts, Standard and Poor's Depository Trust Receipts (SPDRs), and/or short-term fixed income securities for the following purposes:
  - Facilitate investment of active domestic equity manager's cash balances;
  - Eliminate cash drag resulting from cash flows in the S&P 500 Index Portfolios; and/or
  - Equitize cash resulting from domestic equity manager transitions.
1. The Program will not use futures for speculative purposes or to increase the equity exposure greater than the amount of the cash balances identified in policy number two above.
2. The value of the S&P 500 futures contracts and/or SPDRs held in the Program is limited to one percent of the market value of total assets.
3. The Program will comply with the rules of the Commodity Futures Trading Commission (CFTC) and other regulatory agencies.
4. Brokers will be selected for their quality of execution, overall quality of their derivative effort, quality and timeliness of their operation area, and the creditworthiness of the clearing broker. A diversified group of brokers will be used to insure overall quality of trade executions.

5. The Chief Investment Officer is delegated authority to manage the Program internally and may use other investment personnel to implement the Program.
6. The Chief Investment Officer is delegated authority to trade appropriate securities for the Program and may use other investment personnel to conduct trading. The graduated limitations of daily trading authority for S&P 500 Index futures contracts are designated below.

Chief Investment Officer	\$500 million
Director of Internal Equity	\$ 50 million
Director of Fixed Income	\$ 50 million
Investment Officer III	\$ 25 million
Investment Officer II	\$ 10 million
Investment Officer I	\$ 10 million

7. Authorization letters which indicate who may transact business for the Program, including a copy of the most recent Investment Resolution, shall be sent initially to the broker at the time the account is established. Whenever there is a change in authorized personnel, STRS will immediately notify in writing all brokers within twenty four (24) hours.
8. The Chief Investment Officer shall monitor the investment policies and report to the STRS Board quarterly or as otherwise requested.



## MEMORANDUM

**DATE:** 12/28/98  
**TO:** INVESTMENT COMMITTEE  
**FROM:** ALLAN EMKIN  
**RE:** CASH EQUITIZATION PROGRAM

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Pension Consulting Alliance (PCA) has reviewed the proposed policies for the Cash Equitization Program and concurs with the staff's recommendation.

Early in 1998 PCA presented an agenda item to the Investment Committee regarding the impacts of unintended cash positions in the portfolio. Unintended cash result from active domestic equity managers' cash balances, frictional cash in the indexed portfolio and from transitions resulting from manager terminations. "Unintended" (not included as a result of strategic planning decisions) cash creates a variance between the rate of return of the policy asset allocation established by the Investment Committee and the return of the actual portfolio. This variance is frequently called tracking error. Implementation of a cash equitization program minimizes tracking error. Since the expected rate of return of equity is higher than that of cash, over the long term, the program should add value in terms of higher returns and reduce risk in terms of reducing tracking error.

Adoption of the staff's proposal is reasonable and prudent because institutions similar to STRS commonly use cash equitization programs. The staff has, in PCA's opinion, the ability to manage the program prudently at little if any incremental cost. Finally, the Cash Equitization Program Policies address the oversight and control issues to assure that the program meets the Committee's expectations.

AE/AE

PROPOSED  
RESOLUTION OF THE  
TEACHERS' RETIREMENT BOARD  
INVESTMENT COMMITTEE

Subject: Cash Equitization Policy

Resolution No. \_\_\_\_\_

WHEREAS, the Investment Committee of the Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the Cash Equitization Program Policies and has heard oral presentations from Staff; and

WHEREAS, the Staff has recommended the adoption of the Cash Equitization Program Policies; Therefore be it

RESOLVED, that the Investment Committee of the Teachers' Retirement Board adopts the Cash Equitization Policies.

Adopted by:  
Investment Committee  
on \_\_\_\_\_

\_\_\_\_\_  
James D. Mosman  
Chief Executive Officer